FGL's potential merger break could offer upside $FGL

- FGL is in a merger with Anbang that is likely to break later this week
- Despite the likely break, FGL's stock looks interesting on a host of fundamental metrics.
- If the deal does break, it seems a decent bet majority owner HRG will look to sell FGL again in the near future.

So far, I've written about two groups of stocks: stocks undergoing a business model transition (like FC; which I'm long) and stocks trading for less than cash value (like MEIP, which I'm also long).

The next set of stocks I plan on discussing are holding company stocks trading for less than the sum of their parts (SOTP). The first stock I wanted to talk about was HRG (HRG, which I'm long). But a discussion about HRG has to include a decent bit on Fidelity & Guaranty Life (FGL, which I'm also long). FGL's been in the news quite a bit today and I wanted to discuss them before hitting HRG, so I thought I'd start off by addressing FGL separately now.

FGL is an insurance company mainly focused on selling annuities and life insurance to "middle-income Americans". What makes FGL so interesting is that they are in a deal to be bought out by Anbang for $26.80/share. The deal was announced in November 2015, and the outside termination date for the merger (the date either party can walk from the deal if it hasn't closed by) is this Wednesday (February 8th). As I write this, shares are trading for ~$25.50, so the market clearly is not expecting this deal to go through on Wednesday. The market is right to expect the deal not to go through any time soon: the merger requires approval from several regulators, and not only have none of them signed off on the merger, I believe Anbang hasn't even filed the paperwork for approval with several of them.

So we can be pretty reasonably assured that the FGL / Anbang merger is not going through this week. The real question is what is likely to happen once the merger hits the outside termination date and what would happen to FGL w/o the Anbang agreement.

Let's start with the later question: what would happen to FGL if they weren't involved w/ Anbang currently? Well, the first thing we can do is wonder what FGL would be worth if it was trading as a standalone company without a merger agreement. And that's the first thing that interests me about FGL- it's tough for me to reasonably look at FGL and say they'd be trading for a price lower than today’s without the Anbang agreement.

Trailing (LTM) AOI/share (basically, taxed operating income per share) comes in at ~$2.94. At today’s price of ~$25.25, that means FGL is trading for <9x LTM operating earnings. Adjusted book value is ~$27.11, so FGL is trading for just a tick over 0.9x book. Both numbers look pretty cheap to me- you generally trade under book value when you can’t earn your cost of capital, but FGL’s LTM [operating ROE is ~11%](). A median basket of their peers has them trading at 10-11x EPS; if FGL did that, they’d trade at or slightly above book value, which feels about right to me. Bottom line: FGL seems undervalued as a standalone company at today’s prices.

Ok, so maybe FGL’s undervalued as a standalone company. But what would happen if the Anbang deal fell apart this week?

Well, FGL is ~80% owned by HRG, and HRG is [currently undergoing strategic options]() (reading between the lines: they’re looking to liquidate / unwind). Since HRG is both looking to liquidate and has already tried to sell FGL once, it’s probably pretty safe to assume that HRG would turn around and look to sell FGL again in the near future if the Anbang deal fell through.

We know from the [merger proxy that FGL]() was shopped pretty extensively when they were first put up for sale. A bunch of buyers were interested in the mid-$20s range. Anbang initially bid $28 but dropped their bid to $26.80 after doing some DD. So I feel pretty comfortable that there’s interest in FGL outside of Anbang. Indeed, Bloomberg is already reporting the Athene might take a look at [FGL if the Anbang deal falls through]().

If FGL were to be re-shopped in the wake of a deal break, it’s hard not to think that the price they’d fetch would be at least Anbang’s current bid, and potentially more. When FGL was selling itself in late 2015, we were living in a much different world. Interest rates and the stock market were significantly lower, valuations for insurers were lower as well (a basket of the peers listed as FGL’s comps in the proxy is up ~17% since the deal was announced), and the regulatory environment was probably a bit more burdensome (understatement). [FGL’s recent earnings release]() actually includes a quote that says rising interest rates + Trump regulatory environment should benefit them. So just on that basis alone I would think FGL’s valuation would have improved since late 2015.

But it’s not just valuation that has likely improved. FGL’s operating performance has been far above what they were doing / projecting at the time of the deal. If you look at p. 32 of the merger proxy, you can see FGL was forecasting Adjusted EPS of $2.27/share. For FY16, the company [actually earned $2.77/share]() in adjusted AOI (basically, AOI/share is operating net income per share; it excludes gains and losses on their investments so you can see how their core business is doing).

Combine rising valuations and improved performance, and I think FGL may get an improved bid if they were to shop themselves if/when the Anbang deal falls through.

So what's likely to happen on Weds / Thursday, when the company has said they'll provide an update on the deal?

1. **Merger extension**: If I was Anbang, I'd want this deal, as you're almost certainly buying FGL for less than it's worth in today's environment. It's possible they extend the merger for another few months to give Anbang time to get their regulatory house in order. If I'm FGL / HRG, I know I'm selling for less than I'm worth standalone, so I probably don't let Anbang extend the merger w/o significant concessions (a tighter timeline, a breakup fee if Anbang can't complete the merger, maybe even a higher price or a go-shop) and weigh the closer time frame for completing a merger w/ Anbang against the higher upside from reshopping FGL.
2. **Merger breaks and HRG does nothing immediately**: probably the base case. Anbang and FGL admit what's been obvious for a while- this merger is too far behind the regulatory review process to get done. FGL operates standalone for a while so the HRG doesn't look like a desperate seller, FGL buys back some shares if the share price trades down, and in a few month HRG looks to sell FGL again.
3. **Merger breaks and HRG immediately tries to sell**: The Anbang merger breaks, and FGL immediately tries to sell itself again. This might look a bit desperate to potential buyers, but given FGL's operating performance and the improved regulatory environment, there still might be decent bidding for FGL and we could get a price higher than today's.

No matter what happens, it's hard for me to look at today's share price and see too much downside given the HRG's incentives and FGL's operating performance.

Odds and ends

- Anbang does not currently owe FGL a breakup fee if they can't complete the merger. FGL owes Anbang ~$51m (~$0.90/share) in break fees in some circumstances, but I don't think they'd currently apply given Anbang is the reason regulatory approval hasn't been gained. I could be off here, and while it's not ideal for FGL to have to shell out $51m in break fees, it would obviously be a one time expense and doesn't really budge the valuation one way or the other.
- Why does the opportunity exist? While FGL's market is decently big (~$1.5B), HRG owns ~80% of it, which makes the stock somewhat illiquid. The combination of an illiquid stock plus a likely merger break can create a weird dynamic: merger arbitrage people are hesistant to step in because of the illiquidity and the perceived downside on a break, while fundamental players don't want to step in because they might think fundamental downside is limited but they don't want the volatility in share price that can come with a deal break.